

LIBERTY MUTUAL INSURANCE COMPANY POOL
MANAGEMENT’S DISCUSSION AND ANALYSIS
FOR THE PERIOD ENDED DECEMBER 31, 2008 and 2007

NAIC Group Code: 0111

This discussion provides an assessment by management, on a combined basis, of the current financial position, results of operations, cash flow and liquidity, and changes in financial position for the Liberty Mutual Insurance Company Pool (the “Liberty Pool”). In addition to pooling underwriting results, the companies share in related balance sheet underwriting activity. The information presented in this discussion supplements the financial statements, schedules, and exhibits in the 2008 Annual Statements for each company in the Liberty Pool.

ORGANIZATION

The Liberty Pool consists of national property and casualty insurance companies with a diversified distribution channel that includes direct sales agents, independent agents, and independent brokers throughout the United States. The Liberty Pool provides various lines of insurance including private passenger automobile, homeowners, workers compensation, commercial multiple peril, fire, commercial automobile, and general liability.

The pooling arrangement is outlined in the chart below:

		NAIC #	<u>2008</u> <u>Pooling</u> <u>Percentage</u>
Lead Company	Liberty Mutual Insurance Company (“LMIC”)	23043	75.90%
Affiliated Pool Companies	Employers Insurance Company of Wausau (“EICOW”)	21458	10.00%
	Liberty Mutual Fire Insurance Company (“LMFIC”)	23035	10.00%
	Liberty Insurance Corporation (“LIC”)	42404	3.00%
	Wausau Business Insurance Company (“WBIC”)	26069	0.40%
	Wausau Underwriters Insurance Company (“WUIC”)	26042	0.40%
	LM Insurance Corporation (“LMC”)	33600	0.20%
	The First Liberty Insurance Corporation (“FST”)	33588	0.10%
	Wausau General Insurance Company (“WGIC”)	26425	0.00%
	Liberty Personal Insurance Company (“LPIC”)	11746	0.00%
	Liberty Surplus Insurance Corporation (“LSIC”)	10725	0.00%
	Liberty Insurance Company of America (“LICA”)	10337	0.00%
100% Quota Share Affiliated Companies	Liberty Lloyd’s of Texas Insurance Company (“LLOT”)	11041	0.00%
	Liberty County Mutual Insurance Company (“LCMIC”)	19544	0.00%
	Liberty Insurance Underwriters, Inc. (“LIU”)	19917	0.00%
	LM Property & Casualty Insurance Company (“LMPAC”)	32352	0.00%
	LM General Insurance Company (“LMGIC”)	36447	0.00%
	LM Personal Insurance Company (“LMPIC”)	36439	0.00%
	Liberty Mutual Personal Insurance Company (“LMPICO”)	12484	0.00%
	Liberty Mutual Mid-Atlantic Insurance Company (“LMMAIC”)	14486	0.00%

Except for WBIC, WGIC and WUIC, each Affiliated Pool Company cedes its underwriting activity to the Lead Company. WBIC, WGIC and WUIC cede 100% of its direct underwriting activity to EICOW.

With the exception of LMGIC and LMPIC, each 100% Quota Share Affiliated Company cedes its net underwriting activity to the Lead Company. LMGIC and LMPIC cede its net underwriting activity to LMPAC.

After recording the assumed affiliate transactions noted above, the Lead Company records 100% of its external assumed and ceded reinsurance activity.

The Lead Company’s remaining underwriting activity, after processing all internal and external reinsurance, is retroceded to the pool members in accordance with each company’s pool participation percentage, as noted above.

There were no members that are parties to reinsurance agreements with non-affiliated reinsurers covering business subject to the pooling agreement and have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements.

There were no discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the Lead Company and corresponding entries on the assumed and ceded reinsurance schedules of other pooled participants.

The write-off of uncollectible reinsurance is pooled and the provision for reinsurance is recognized by the entity placing the outbound external reinsurance.

Effective January 1, 2008, Bridgefield Employers Insurance Company and Bridgefield Casualty Insurance Company novated their 100% Quota Share Reinsurance Agreements with Liberty Mutual Insurance Company, the Lead Company in the Liberty Pool, to substitute Peerless Insurance Company as the reinsurer.

Also, effective January 1, 2008, the Liberty Mutual Pool reinsured 100% of its Surety business through an inter-company reinsurance agreement with Peerless Insurance Company.

Pursuant to the approval of the appropriate state insurance departments, effective January 1, 2009, the Liberty Mutual Pool participation percentages were revised as follows:

	<u>2009</u>	<u>2008</u>
Liberty Mutual Insurance Company	75.0%	75.9%
Employers Insurance Company of Wausau	8.0%	10.0%
Liberty Mutual Fire Insurance Company	12.9%	10.0%

On September 22, 2008, LIH US P&C Corporation, a downstream non-insurance holding company of the Liberty Pool, acquired all of the common stock of Safeco Corporation, a non-insurance holding company and parent to 15 property and casualty insurance companies, at a cost of \$6.2 billion.

RESULTS OF OPERATIONS

The Liberty Pool's net operating results for 2008 and 2007 and certain key financial ratios are presented below.

(Dollars in thousands)

	<u>2008</u>	<u>2007</u>
Net written premiums	\$10,706,584	\$12,149,576
Net earned premiums	\$11,110,601	\$11,800,710
Losses incurred	7,527,303	7,307,054
LAE incurred	1,754,709	1,872,083
Underwriting expenses	2,468,783	3,275,254
Dividends to policyholders	26,791	69,773
Underwriting losses	(666,985)	(723,454)
Net investment income	2,406,516	1,536,113
Realized investment gains	78,175	249,613
Other expenses	(148,602)	(135,626)
Income before income taxes	1,669,104	926,646
Federal and foreign income tax expense	27,677	193,752
Net income	<u>\$1,641,427</u>	<u>\$732,894</u>
	<u>2008</u>	<u>2007</u>
Net loss ratio	67.7%	61.9%
Net loss and LAE ratio	83.5%	77.8%
Underwriting ratio	23.1%	26.9%
Dividend ratio	0.2%	0.6%
Combined ratio	106.8%	105.3%
Combined ratio (ex. catastrophes)	96.8%	102.9%

Net written premiums decreased \$1.4 billion, -11.9%, from \$12.1 billion in 2007 to \$10.7 billion in 2008. The movement of Bridgefield Casualty Insurance Company and Bridgefield Employers Insurance Company along with the transfer of the in force Liberty Surety business to the Peerless Pool as of January 1, 2008 ("2008 transferred business"), combined with an increase in externally ceded reinsurance and lower retention rates across most commercial lines of business were the primary drivers for this decrease.

The increase in externally ceded reinsurance was driven by a new reinsurance contract entered into in the 4th Quarter of 2008 where a pro rata portion of the Pool's direct written homeowners premiums were ceded. Lower retention levels were experienced across most commercial lines of business as a result of an increasingly competitive rate environment and lower audit and retrospectively rated premium. These decreases were partially offset by new business growth and strong customer retention on personal lines. Also partially offsetting this decrease was an increase in assumed voluntary business as well as higher commercial multiple peril and fire premium due to a reduction in utilization of ceded reinsurance. In addition, the pool experienced net new business growth in general liability and workers' compensation related to large accounts with multi-year exposure. The decrease in earned premium of \$690 million in 2008 is consistent with the decrease in net written premiums.

The Liberty Pool's combined ratio increased 1.5 points from the prior year to 106.8%. The increase was driven by a 5.7 point increase in the net loss and LAE ratio, and partially offset by a 3.8 point decrease in the underwriting expense ratio and 0.4 point decrease in the dividend ratio. The increase in the loss and LAE ratio reflects significant catastrophe losses over the prior year, partially offset by favorable development on prior year reserves. The decrease in the underwriting ratio was driven primarily by reduced profit sharing and commission expenses related to the Fourth Quarter homeowners reinsurance contract, as well as a decrease in employee relations and welfare expenses compared to the prior period.

In 2008, the Liberty Pool reduced loss and LAE expenses incurred for insured events of prior years by \$333 million, compared to the \$312 million added in 2007. In 2007, the adverse development was driven by workers' compensation and other liability, partially offset by favorable development for private passenger automobile. In 2008, the favorable development was driven primarily by private passenger automobile, products liability and other liability lines of business.

Catastrophes are an inherent risk of the property-casualty insurance business and have contributed to material period-to-period fluctuations in the Liberty Pool's results of operations and financial position. The level of catastrophe losses experienced in any period cannot be predicted and can be material to the results of operations and financial position of the Liberty Pool. During the years ended December 31, 2008 and 2007 catastrophe losses were \$1.1 billion and \$290 million, respectively.

In 2008, the Liberty Pool's net investment income increased \$870 million to \$2.4 billion from \$1.5 billion in 2007. This increase can be attributed to affiliated dividends of \$993 million and reinvestment of cash flow from operations, partially offset by lower investment yields on tax-exempt securities and the sale of bonds (refer to Assets section).

In 2008, realized capital gains were \$78 million, a \$172 million decrease from the prior year. The decrease was primarily driven by impairments, offset by gains on derivatives contracts the Pool entered into to partially hedge its equity exposure.

The Liberty Pool's 2008 federal and foreign income tax incurred was \$28 million, as compared to \$194 million in 2007. The decrease was primarily attributable to lower taxable income in 2008, as well as, the effective tax rate decreasing due to permanent differences. The effective rate went from 21% in 2007 to 2% in 2008. Impacting the effective rate in 2008 was increases in affiliated dividends of \$1.48 billion.

FINANCIAL POSITION

The Liberty Pool's financial position at December 31, 2008 and 2007 was as follows:

(Dollars in thousands)

	<u>2008</u>	<u>2007</u>
Assets		
Bonds	\$16,382,055	\$21,830,256
Common and preferred stock	698,135	2,409,802
Investment in affiliates	11,563,422	8,503,312
Cash and short-term investments	1,820,772	1,299,363
Other invested assets	3,067,250	2,640,141
Premiums receivable (net)	3,952,210	3,826,554
Reinsurance recoverable on paid losses (net)	466,993	637,927
Deferred tax asset (net)	1,044,849	834,332
Funds held by affiliates and other reinsurers	17,940	28,704
Other admitted assets	1,447,552	1,133,020
Total assets	<u>\$40,461,178</u>	<u>\$43,143,411</u>
Liabilities		
Unpaid loss and LAE	\$19,901,391	\$20,023,450
Unearned premiums	4,374,334	4,846,758
Funds held under reinsurance contracts	1,833,323	1,911,152
Ceded reinsurance premiums payables	606,237	722,002
Other liabilities	1,469,273	1,539,095
Total liabilities	<u>28,184,558</u>	<u>29,042,457</u>
Policyholders' surplus	<u>12,276,620</u>	<u>14,100,954</u>
Total liabilities and policyholders' surplus	<u>\$40,461,178</u>	<u>\$43,143,411</u>

Assets

The Liberty Pool's invested assets represent 82.9% of total admitted assets. Excluding the Liberty Pool's investment in affiliates, invested assets primarily consisted of bonds and short-term investments of 74.6%.

Bonds consisted of 25.5% U.S. government and U.S. government backed securities, 33.3% state and municipal bonds and 41.2% of corporate and other foreign bonds. The Liberty Pool's bond portfolio remains high quality, with approximately 93.2% rated as "investment grade" by the National Association of Insurance Commissioners (NAIC). Management believes the high quality and structuring of the Liberty Pool's invested assets and the consistent level of investment income generated by the assets will ensure adequate liquidity to meet its current and future obligations.

Bonds of \$16.4 billion decreased \$5.4 billion from \$21.8 billion in 2007. This decrease was driven by the sale of fixed maturities to finance the Safeco Corporation acquisition, coupled with the transfer of assets to the Peerless Pool due to the 2008 transferred business.

At December 31, 2008, the Liberty Pool's unaffiliated stock portfolio totaled \$698 million, reflecting a 71.1% decrease over 2007. The decrease reflects the execution of a program to reduce the Pool's existing and acquired exposure to the common equity markets, other-than-temporary impairments on preferred stocks and a general decline in equity market indices.

The Liberty Pool's investment in affiliates increased \$3.1 billion between 2007 and 2008. The increase was primarily a result of the Liberty Mutual Group's acquisition of the Safeco Corporation on September 22, 2008, for approximately \$6.2 billion. The Pool experienced a \$3.2 billion unrealized loss due to non-admitted goodwill resulting from the Safeco acquisition, which is held by LIH US P&C Corporation, a downstream non-insurance holding company of the Liberty Pool.

As of December 31, 2008 the Liberty Pool had approximately \$448 million, or less than 1.4% of invested assets, in company occupied properties. The Liberty Pool's exposure to sub-prime mortgage related risk is not material.

Other invested assets totaled \$3.1 billion at December 31, 2008, an increase of \$427 million from 2007. The increase is largely due to an increase in the commercial mortgage loan portfolio and additional investments in limited partnership stocks.

The Liberty Pool's admitted premiums receivable of \$4.0 billion at December 31, 2008 increased \$126 million from December 31, 2007. Consistent with sound credit policy, the Liberty Pool's receivables are actively managed and a significant portion of the commercial lines receivables are collateralized.

The Liberty Pool's total reinsurance recoverable on paid losses and loss adjustment expenses decreased approximately \$171 million to a balance of \$467 million in 2008. The reinsurance recoverable balance represented approximately 3.8% of total policyholders' surplus as at December 31, 2008. The Liberty Pool actively monitors the credit quality of the reinsurance portfolio and maintains guidelines that govern the Liberty Pool's purchase and use of reinsurance. There were no material reinsurance recoverables in dispute at December 31, 2008.

Other admitted assets were \$1.4 billion at December 31, 2008, an increase of \$0.3 billion from December 31, 2007. This increase was driven primarily by an increase in receivable from affiliates and cash surrender value life insurance.

Liabilities

Liabilities of the Liberty Pool totaled \$28.2 billion at December 31, 2008, a 3.0% decrease from December 31, 2007.

The Liberty Pool's reserves for loss and loss adjustment expenses decreased \$122 million to \$19.9 billion in 2008. The decrease was primarily due to the 2008 transferred business, partially offset by new business growth, general cost increases and higher catastrophe and non-catastrophe losses compared to 2007.

Property-casualty insurance unpaid loss and loss adjustment expenses represent the Liberty Pool's best estimate of amounts necessary to settle all outstanding claims, including claims that are incurred but not reported as of the reporting date. The Liberty Pool's reserve projections are based primarily on detailed analysis of the facts in each case, experience with similar cases and various historical development patterns. Consideration is given to items such as case reserving trends and claims settlement practices, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes. All of these factors can affect the estimation of reserves.

Establishing loss reserves, including loss reserves for catastrophic events that have occurred, is an estimation process. Many factors can ultimately affect the final settlement of a claim and, therefore, the necessary reserve. Changes in the law, results of litigated cases, medical costs, and cost of repair materials and labor rates can all affect ultimate claim costs. In addition, time can be a critical part of reserving determinations, since the longer the span between the incidence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement can be. Accordingly, "short-tail" claims, such as property damage claims, tend to be easier to estimate than "long-tail" claims, such as workers compensation or general liability claims.

As information develops that varies from past experience, provides additional data, or in some cases, augments data that previously was not considered sufficient for use in determining reserves, changes in the Liberty Pool's estimate of ultimate liabilities may be required. The effects of these changes are reflected in current operating results.

The Liberty Pool companies have not discounted unpaid property and casualty insurance claims and claim adjustment expenses other than tabular discounting on the long-term indemnity portion of workers compensation claims and certain asbestos structured settlements.

Asbestos and environmental reserves decreased approximately \$182 million in 2008, primarily due to ongoing settlement activity.

The unearned premium reserve decreased \$472 million to \$4.4 billion in 2008 compared to \$4.8 billion in 2007. The decrease over prior year corresponds with the decrease in net written premiums.

Other liabilities were approximately \$1.5 billion at December 31, 2008, relatively flat compared to 2007.

Policyholders' Surplus and Leverage

Total policyholders' surplus was \$12.3 billion at December 31, 2008, a \$1.8 billion decrease from December 31, 2007. The decrease in surplus was primarily driven by net unrealized losses of \$5.6 billion, of which \$3.2 billion resulted from an unrealized loss due to non-admitted goodwill related to the Safeco Corporation acquisition, partially offset by net income of \$1.6 billion and capital contributions of \$2.2 billion.

The Liberty Pool converts foreign currencies into U.S. dollars on each line of the balance sheet and earnings statement consistent with the NAIC Statement of Statutory Accounting Principles No. 23, *Foreign Currency Transactions and Translations*. This methodology requires the translation of balance sheet items at the spot rate in effect on the balance sheet date and the translation of earnings statement items at the average exchange rate for the period. Gains and losses resulting from changes in exchange rates are recorded directly to surplus. Because different exchange rates are used on the balance sheet and earnings statement and these rates fluctuate, the change between years of certain balance sheet items will not correspond with the respective activity in the earnings statement.

The Liberty Pool's net written premium to surplus ratio was 0.9 to 1.0 in 2008, consistent with 2007. The reserve to surplus ratio increased from 1.4 to 1.0 in 2007 to 1.6 to 1.0 in 2008. The increase in reserve to surplus ratio was driven by the decrease in policyholders' surplus outpacing the decrease in net written premiums and reserves.

All the companies in the Liberty Pool exceed the minimum risk-based capital requirements developed by the NAIC and prescribed by the respective states of domicile.

At December 31, 2008 and 2007, the Liberty Pool's surplus included surplus notes relatively flat to 2007, at \$892 million, with annual interest rates ranging from 7.7% to 8.5%. The maturity dates range from 2025 to 2097.

CASH FLOW AND LIQUIDITY

Cash and short-term investments totaled \$1.8 billion at December 31, 2008, compared to \$1.3 billion at December 31, 2007. The increase of \$555 million was primarily driven by cash generated from operations and from the liquidation of common stocks.

The Liberty Pool invests policyholder premiums in assets whose maturities correspond to the expected payout of loss and LAE reserves. Management believes that current and future liquidity needs will continue to be met primarily by operations.

This Management's Discussion and Analysis provides Management's assessment of the financial position, results of operations, cash flow and liquidity, and changes in financial position for the Liberty Pool as of and for the year ended December 31, 2008. Representations contained herein are those of Management according to the best of their information, knowledge, and belief.

March 31, 2009